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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 03-0407
Income Tax
For Tax Years 1998-2001

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ISSUE

I. Gross Income Tax—Property Management Services

Authority: IC 6-2.1-2-2; 45 IAC 1.1-1-2; 45 IAC 1.1-1-3; 45 IAC 1.1-6-10

Taxpayer protests the imposition of gross income tax on income from its management of rental property.

II. Adjusted Gross Income Tax—Property Management Services

Authority: IC 6-3-2-2; IC 6-8.1-5-2; 45 IAC 3.1-1-38

Taxpayer protests the imposition of adjusted gross income tax on income from its management of rental property.

III. Tax Administration—Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty and interest.

STATEMENT OF FACTS

Taxpayer is an Ohio company which manages an apartment complex in Indiana owned by a partnership. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for gross income tax in adjustments one through four, adjusted gross income tax in adjustments five through nine, and a ten percent negligence penalty and interest. Taxpayer protests these proposed assessments. Further facts will be supplied as required.

I. Gross Income Tax—Property Management Services

DISCUSSION

Taxpayer protests the imposition of gross income tax for the years in question. Taxpayer states that it has no employees in Indiana and that all of the income-generating activity occurs at its headquarters in Ohio. The Department conducted an audit and, after reviewing the management agreement between taxpayer and the partnership which owns the apartment complex, determined that taxpayer had gross income from activities in Indiana and issued proposed assessments on that gross income.

The relevant statute in effect at the time (Indiana has since repealed the gross income tax) was IC 6-2.1-2-2(a) which states:

> An income tax, known as the gross income tax, is imposed upon the receipt of:
> (1) the entire taxable gross income of a taxpayer who is a resident of Indiana; and
> (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana.

Taxpayer states that it was acting in an agency capacity when it collected rent in Indiana. The relevant regulation was 45 IAC 1.1-1-2, which states:

> (a) "Agent" means a person or entity authorized by another to transact business on its behalf.
> (b) A taxpayer will qualify as an agent if it meets both of the following requirements:
> (1) The taxpayer must be under the control of another. An agency relationship is not established unless the taxpayer is under the control of another in transacting business on its behalf. The relationship must be intended by both parties and may be established by contract or implied from the conduct of the parties. The representation of one (1) party that it is the agent of another party without the manifestation of consent and control by the alleged principal is insufficient to establish an agency relationship.
> (2) The taxpayer must not have any right, title, or interest in the money or property received from the transaction. The income must pass through, actually or substantially, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal.

Also, 45 IAC 1.1-6-10 states:

> (a) Income received in an agency capacity is not included in the agent's gross income. This is because the income was received by the agent for the principal's benefit.
> (b) The exclusion provided by subsection (a) will not apply if an agency relationship is not established or if the agent has any right, title, or interest in the money or property received from the transaction.
> (c) Where property is purchased by a taxpayer for another, title need not vest immediately in the principal in order for the taxpayer's reimbursement to be excluded from gross income if the agency relationship actually exists. However, where property is purchased from the principal by the taxpayer and resold to a third party, the receipts from the sale are included in the taxpayer's gross income.
> (d) The reimbursement of amounts paid to a third party under an agreement to be reimbursed by another for expenses incurred and paid to a third party is not excluded from gross income unless the party being reimbursed qualifies as the agent of the party making the reimbursement under 45 IAC 1.1-1-2. A reimbursement of a taxpayer's own expenses are never excluded from gross income.
> (e) The mere execution of an agency contract will not create an agency relationship. If the agent takes title to the products, operates under its own name, and cannot bind the principal in contracts, an agency relationship has not been established.

As part of its determination that taxpayer was not in a true agency relationship with the owner of the property, the Department referred to the management agreement, which explains the taxpayer's duties. The Department determined that the taxpayer was allowed to keep certain late fees and similar charges without remitting them to the owner. A further review of the management agreement shows that taxpayer was not allowed to keep these fees and charges. The agreement states that taxpayer was not required to explain where the additional money came from when remitting funds to the owner. 45 IAC 1.1-6-10 explains that an agency relationship does not exist if the agent takes title to the products, operates under its own name and cannot bind the principal in contracts. All three factors must be satisfied to find that an agency relationship does not exist. Here, taxpayer does not take title to the products and it can bind the principal in contracts, therefore all three factors are not satisfied and in this case there is an agency relationship under 45 IAC 1.1-6-10.

The Department also referred to the management agreement to establish that taxpayer had Indiana employees. The agreement calls for the owner to reimburse taxpayer for payroll expenses. The Department took this to mean that taxpayer had employees it was paying in Indiana. The agreement also explicitly states that all employees are employees of the owner, not the taxpayer. The reimbursements were for payroll expenses of the owner paid by taxpayer. The reimbursement for payroll expenses in this case are also subject to the agency regulations 45 IAC 1.1-1-2 and 45 IAC 1.1-6-10. Again, taxpayer satisfies these regulations.

Next, the Department referred to 45 IAC 1.1-1-3, which states:

> (a) A "business situs" arises where possession and control of a property right have been localized in some business or investment activity away from the owner's domicile.
> (b) A taxpayer may establish a business situs in ways, including, but not limited to, the following:
> (1) Use, occupancy, or operation of an office, shop, construction site, store, warehouse, factory, agency route, or other place where the taxpayer's affairs are conducted.
> (2) Performance of services.
> (3) Maintenance of an inventory or stocks of goods for sale, distribution, or manufacture.
> (4) Sale or distribution of merchandise from company-owned vehicles where title to the goods passes at the time of sale or distribution.
> (5) Acceptance of orders without the right of approval or rejection in another state.
> (6) Ownership, leasing, rental, or other business activities connected with income-producing property (real or personal).
> (7) Ownership (in whole or part) of a partnership doing business in Indiana unless the ownership is that of a limited partner who does not participate in the control of the business.
> (8) Other business or investment activities, other than de minimis performed on behalf of the taxpayer by an employee of the taxpayer. These activities shall be considered together, not in isolation, in deciding if they are de minimis.

The Department concluded that taxpayer was providing services in Indiana and therefore had a business situs as provided in 45 IAC 1.1-3(b)(2). Gross income tax was imposed on the fees taxpayer received from the partnership for services associated with managing the apartment complex. As previously explained, all employees at the complex were employees of the partnership. All reports were generated at taxpayer's Ohio headquarters. There is insufficient evidence to support the conclusion that any income-generating activity by taxpayer took place in Indiana. 45 IAC 1.1-1-3(b)(2) requires the services to be performed in Indiana and ,since taxpayer had no Indiana-performed services, taxpayer did not have an Indiana business situs under 45 IAC 1.1-1-3(b)(2).

In conclusion, based on the management agreement, taxpayer's relationship qualified as an agency relationship under 45 IAC 1.1-1-2 and 45 IAC 1.1-6-10. The management agreement establishes that all employees at the apartment complex are employees of the owner, not the taxpayer. The services referred to in the management agreement are performed in Ohio, and are not subject to gross income tax in Indiana.

FINDING

Taxpayer's protest is sustained.

II. Adjusted Gross Income Tax—Property Management Services

DISCUSSION

Taxpayer protests the imposition of adjusted gross income tax. The Department reviewed the management agreement between taxpayer and the partnership which owned the apartment complex in question. The Department determined that taxpayer had adjusted gross income from Indiana sources and issued proposed assessments on that income.

The adjusted gross income tax is established at IC 6-3-2-2, which states in relevant part:

> (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
>
> (1) income from real or tangible personal property located in this state;
>
> (2) income from doing business in this state;
>
> (3) income from a trade or profession conducted in this state;
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> (4) compensation for labor or services rendered within this state; and
>
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.
>
> In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter) only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (r) is considered derived from sources within Indiana.

The Department referred to 45 IAC 3.1-1-38(4), which states:

> For apportionment purposes, a taxpayer is “doing business” in a state if it operates a business enterprise or activity in such state including, but not limited to:
>
> (1) Maintenance of an office or other place of business in the state
>
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
>
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution

> *(4) Rendering services to customers in the state*
> (5) Ownership, rental or operation of a business or of property (real or personal) in the state
> (6) Acceptance of orders in the state
> (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.
> As stated in Regulation 6-3-2-2(b)(010) *[45 IAC 3.1-1-37]*, corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n).
> (emphasis added)

As explained in Issue I, review of the management agreement establishes that taxpayer did not render services to its customer in Indiana. The Department made several adjustments to establish apportionment factors to determine taxpayer's Indiana-apportioned income, and extended the audit period to six years under IC 6-8.1-5-2(b).

Since it has already been explained in Issue I that taxpayer had no Indiana activity, there is no Indiana-source income to apportion. The services taxpayer rendered to its customer occurred in Ohio, therefore taxpayer is not "doing business" in Indiana under 45 IAC 3.1-1-38(4). Taxpayer did not understate Indiana income by at least twenty five percent as required by IC 6-8.1-5-2(b).

FINDING

Taxpayer's protest is sustained.

III. Tax Administration—Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of penalty. The Department refers to IC 6-8.1-10-2.1(a), which states in relevant part:

> If a person:
> …
> (3) incurs, upon examination by the department, a deficiency that is due to negligence;
> …
> the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws,

> rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC 6-8.1-10-2.1(a). Taxpayer has affirmatively established by documentation and explanation that there was no failure to pay the deficiency and so there was no negligence, as required by 45 IAC 15-11-2(c). The negligence penalty shall be waived.

FINDING

Taxpayer's protest is sustained.

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